

MEMORANDUM

TO: PERAC Commissioners

FROM: Joseph E. Connarton, Executive Director *JEC*

RE: Chronology of PERAC Actions Relative to Middlesex

DATE: June 18, 2003

In an effort to assist the Commission to fully understand the events, communications, and conversations held (by me and members of the senior staff) relative to the substantial loss to the Middlesex Retirement System pension fund, I have outlined a detailed chronology for your review.

May 8, 2003

Attorney Thomas Gibson telephoned me and informed me that a problem had arisen with a Middlesex Retirement investment and that the Board would like to meet with PERAC staff to discuss it. The meeting was held on the afternoon of May 15 and attended by Joseph E. Connarton, Executive Director, Joseph I. Martin, Deputy Executive Director, Barbara J. Phillips, General Counsel from PERAC; James Fahey, Chairman, Nancy O'Neil, Investments from Middlesex Retirement Board; Thomas Gibson, Attorney for the Middlesex Retirement Board; Gustavos Aristozabal, Bart Early, Wainwright Consultants; Anne Buckley, Attorney for Wainwright; and John Corrigan and Willis Riccio, Attorneys retained by Middlesex in regards to this matter.

Mr. Fahey thanked everyone for attending and requested confidentiality in light of the fact that the Board was seeking some form of settlement and had retained the law firm of Adler & Pollack to pursue litigation. He assured us that in regards to PERAC, the Board would provide full and continuing disclosure and updates on activity relative to this matter.

Ms. Phillips stated that PERAC had a responsibility to report these matters to the Commission and that we may be required to take regulatory action either through a Sub-Committee or the full Commission. She made it clear that we could not give any assurances not to disclose the matter and she indicated that the meeting should not proceed if the Board was unwilling to accept that fact. Mr. Connarton stated that it would clearly be necessary to apprise the Commission of the situation at its next meeting of June 11.



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Mr. Fahey continued, stating that a situation had arisen with respect to a currency overlay manager, Cambridge Financial Management and Mellon Bank, that the potential for a substantial loss existed but that there are "ample sources of recovery".

Mr. Fahey outlined the circumstances that led to the situation as follows:

- James Kneafsey, the manager of the account and principal of Cambridge Financial called Mr. Fahey on April 2 or 3 and informed him that he would not be able to attend the annual Middlesex Conference scheduled for April 7 - 9 as he had to go into the hospital for minor surgery. Mr. Kneafsey stated that Pamela Otis, Vice President of Cambridge Financial (and also his wife) would handle the account in his absence.
- On April 22, Mr. Fahey received a phone call from Ms. Otis informing him that on April 21 Mr. Kneafsey had died and that there were no problems with the account.
- On April 22-23 Mr. Fahey called Gustavos Aristizabal of Wainwright and Fred Bissett of A.G. Bissett, the other currency overlay manager for Middlesex, informing them that Ms. Otis had stated that she would not be going forward with Cambridge Financial.
- On April 28, Ms. Otis told Mr. Fahey that it was impossible for her to continue and that she would cooperate with Mr. Aristizabal and Mr. Bissett.
- On April 30, Goldman Sachs contacted Mr. Aristizabal; a contraparty on Cambridge Financial trades, stating that Ms. Otis was not hands-on in dealing with the account and that Goldman Sachs wanted to make Middlesex aware of the circumstances.
- On May 1-2, Mr. Aristizabal sought information regarding the account status.
- On May 2, Ms. Otis informed Mr. Fahey and Mr. Aristozabal that she was aware of the status of the account but was vague as to the particulars.
- On May 3, Mr. Aristizabal, Mr. Fahey, Lawrence Driscoll, Middlesex Retirement Board members, Mr. O'Neil, Mr. Gibson, Mr. Early and Saro Picciotto, CEO of Wainwright met to discuss the situation – "what were the holdings and what did they mean?". The participants paired off and reviewed the Goldman data and the Mellon data (Mellon was also a contraparty in trades made by Cambridge). According to Mr. Fahey, Mellon had not, as of that date (May 15), provided all the information requested.
- May 6, Mr. Bissett informed MRB that he was unaware of the "mechanism" used by Mr. Kneafsey in managing the account. Mr. Fahey stated that another firm, Analytic, used a similar strategy to that of Cambridge Financial. Beginning on May 6, according to Mr. Fahey, Analytic began to manage the account and

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executed "forward transactions that covered the naked positions and contained the parameters of the loss". Wainwright began to explore law firms with expertise in the area.

- On May 8, Mr. Driscoll informed the Middlesex Board members that the Board authorized further investigation by Wainwright and retention of Adler & Pollack. The Board sought a quick resolution asserting that Mellon violated its contractual agreement with the Board in failing to independently value the Cambridge account and that its reports merely restated the managers' valuations leading to the Board being unaware of the actual status of the account.
- May 9, a meeting with Mellon was cancelled. Middlesex sought to settle the matter by having Mellon pay Middlesex \$1.6 million (the value of the account that Middlesex asserts is reflected in the March 31 Mellon report) and Mellon assuming the positions in the account as of that date. Mellon has hired Goodwin Proctor.

Mr. Fahey stated that Middlesex "can and will unwind the positions over the course of the calendar year", that the Board will pursue legal options, the SEC is now involved and that another pension fund has twice the Middlesex exposure.

Mr. Aristizabal, Mr. Early and Mr. Buckley stated that Cambridge Financial was trading with Goldman Sachs and a Division of Mellon. Mr. Early stated that there is "not a realized loss at this point". He added that 50% of the trades in the account were through Mellon and that Mellon had indicated that they were valuing the account. He added that there were no manager statements, that all information came through Mellon. Mr. Early stated that Wainwright's review of the account indicates that the problem began as early as 2001.

In response to a direct question from PERAC staff regarding the potential for further losses, Ms. Buckley stated that the strategy put into place through Analytic would prevent further losses.

Mr. Corrigan and Mr. Riccio reviewed the legal strategy stating that the 2001 RFP response from Mellon and the contract established a duty to independently price the portfolio. A statement from James Mahoney of Mellon to Mr. Aristizabal indicated that Mellon did not independently price the account and that the Board's case rested on the failure of Mellon to independently price the account. The firm has commenced drafting the complaint and anticipates filing in federal district court. The firm believes this is a "very winnable" action. The account never showed a loss during the entire period.

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After the meeting Mr. Martin, Ms. Phillips and I, discussed the matter based on information provided by the Board, the consultant and the attorneys. We concluded that:

- (1) the account was being managed by Analytic,
- (2) steps had been taken to curtail further losses, ("forward transactions that covered the naked positions and contained the parameters of the loss" had been executed),
- (3) the Board was aggressively pursuing a legal strategy to recoup the losses,
- (4) it was necessary to follow up with the Board, Wainwright and the other pension fund, if possible, to assess the situation further and to determine what immediate steps PERAC should take and,
- (5) that it would be necessary to, with Commission approval, initiate a wide ranging investigation of the circumstances surrounding the Middlesex investment with Cambridge Financial Management.

MAY 19, 2003

A meeting was convened at which the matter was discussed with Investment Director Robert Dennis. It was decided that Mr. Dennis would contact Wainwright seeking confirmation and elaboration on the information provided by Middlesex at the previous meeting. In addition, a meeting would be arranged with the other pension fund confronting the problem to review the actions taken by that fund as well as the circumstances as known by that fund.

May 20, 2003

Mr. Dennis called Mr. Early of Wainwright, however, Mr. Early would not discuss the matter with him. After clarification of Mr. Dennis' authority on May 21, he spoke with Mr. Aristizabal and Mr. Early. They outlined a timeline of events (including the involvement of a third party marketer, Tom Kelly), the nature of the immediate problem (short-dated puts owned in the account were not rolled over, resulting in a naked short position), the advice sought and received from Citibank (liquidate), Mellon's inadequate (according to Wainwright) pricing methods and the fact that no one had met with Cambridge Financial since the summer of 2001.

May 22, 2003

Mr. Dennis was informed by Mr. Aristizabal that, based on Wainwright's recommendation, Middlesex would not liquidate the account but has instead stabilized it

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after selecting Analytic Investors to oversee the portfolio and make recommendations as to what course to follow. Mr. Aristizabal also informed Mr. Dennis that Middlesex pursued currency overlay after Wainwright had advised against it.

May 23, 2003

Mr. Dennis e-mailed Mr. Aristizabal indicating that in light of the emergency nature of the situation he did not expect regulatory difficulty with respect to the hiring of Analytic as long as a letter of notification and other information was supplied to PERAC.

May 27, 2003

Mr. Martin and I met with the Executive Director of the other pension fund referred to at the original meeting. The Executive Director informed Mr. Martin and I that the fund was confronted by the same issues. He stated that the fund had liquidated its account and would in all likelihood pursue litigation at a future date. When informed that the Middlesex had kept the account active while limiting its potential losses he said that was a possible approach but that his fund had decided to liquidate.

May 30, 2003

Mr. Dennis called Mr. Aristizabal for an update and was informed that Middlesex was looking for expert witnesses to analyze what went wrong. Mr. Aristizabal stated that Cambridge Financial Reports went "mostly" to Mellon and that it would take several months to input the data and analyze it. Wainwright still did not have a good grasp on what Cambridge had been doing. Gains had been recently taken on positions in the portfolio.

PERAC sent a letter to Middlesex stating that the actions taken by Middlesex with respect to the Cambridge Financial account raised several regulatory concerns. The letter also stated that at the meeting of May 15 Wainwright and Middlesex stated that the action taken "had contained the parameters of the possible loss and protected MRB from any loss beyond that discussed at the meeting". The letter also requested the following:

1. A detailed chronology of the events that have taken place with respect to the CFM account since the date of Mr. Kneafsey's death.
2. Disclosure forms completed by any and all firms and individuals retained by MRB subsequent to Mr. Kneafsey's death and in relation to the CFM account.

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3. Copies of any contracts, instructions, requests for proposals, consultant recommendations or other documents pertaining to the actions taken by MRB with respect to the account since Mr. Kneafsey's death.
4. A supplemental regulation request that addresses the regulatory compliance issues relating to the actions taken by MRB with respect to the account since Mr. Kneafsey's death.
5. A precise description of the status of the account on the date of Mr. Kneafsey's death.
6. A precise description of the actions taken with respect to the account since Mr. Kneafsey's death including copies of any consultant recommendations as well as a justification for those actions.

All of these items focus exclusively on the actions taken by Middlesex and other parties subsequent to Mr. Kneafsey's death. A response was to be received by PERAC by June 9.

June 2, 2003

Mr. Dennis called Mr. Aristizabal and inquired about the guidelines given to Cambridge Financial when it began in 1999. Mr. Aristizabal's response was somewhat vague.

June 9, 2003

At a meeting was held with Mr. Fahey and Mr. Gibson, they provided the Middlesex response to the PERAC letter of May 30. It included a chronology of events as requested.

- The Board indicated that no vendors had been retained with respect to this matter and that the arrangement relative to Analytic's involvement was that "Analytic, a currency overlay firm familiar with the CFM philosophy, has provided consulting assistance to A. G. Bissett in this regard but has no contractual relationship with the Board".
- In responding to the request for copies of "contracts, instructions, request for proposals, consultant recommendations or other documents pertaining to the actions taken by MRB with respect to the account since Mr. Kneafsey's death". The Board stated that outside of the law firm no vendors have been engaged and that, "Accordingly, with reference to instructions and consultant recommendations, there have been none relating to the CFM account." The response also referred the reader to the chronology. The Board asserted "it would

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appear that no supplemental regulation request should be required as the Board's actions in this matter raise no issue of regulatory compliance."

- With respect to the precise description of the account status as of the date of Mr. Kneafsey's death the Board stated. "There has been no information made available to the board or its advisors which would allow it to provide a precise description of the account on that date." The Board offered to provide Mellon statements for March and April.
- Finally, in response to the request for a description of the actions taken with respect to the account since the date of Mr. Kneafsey's death including copies of any consultant recommendations as well as justification for those actions the Board again referred to the chronology and the previous responses.

Reflected in these events is the concern for the status of the account and the desire to obtain comprehensive and accurate information about that status. PERAC received assurances from various parties that the strategy put in place by Middlesex protects against further losses. These included the statements that "forward transactions that covered the naked positions and contained the parameters of the loss" had been executed, that Analytic was now managing the account (Mr. Fahey, May 15) and that based on Wainwright's recommendation, Middlesex had not liquidated the account but had instead stabilized it after selecting Analytic Investors to oversee the portfolio and make recommendations as to what course to follow (Mr. Aristizabal, May 22). Although other parties may have acted differently that party did not indicate that the Middlesex strategy was unreasonable.

The approach taken by PERAC staff was to ensure that action to protect the assets had been taken and to gather information to enable a full briefing to the Commission and support a recommendation that an investigation be pursued. It was anticipated that the response from Middlesex received on June 9 would provide satisfactory documentation to confirm the verbal assurances provided earlier. That material was not provided until after the Commission meeting.

4/28/2003

Sell Long Options
Buyback GBP Call 6/2/03
Settle GBP Call 6/19/03
Old GBPs
Old Eur
Old CHF
Current CHF
Current JPY
Current GBP
Current EUR

Forward

6-19-03

MCRF 09060002	Trade Date	Base Currency	Value Date	Spot	Forward	Outright	Exposure	Counterparty	Gain / Loss
USD/GBP	05/08/03	(\$9,894,167.67)	06/02/03	\$1.60080	(\$0.00207)	\$1.59873	6,188,767.13	Mellon	2084686
USD/GBP	05/19/03	(\$4,000,000.00)	06/02/03	\$1.63320	(\$0.00120)	\$1.63200	2,450,980.39	Mellon	2109643
USD/GBP	05/28/03	\$13,894,167.67	06/02/03	\$1.65307		\$1.65307	(8,405,069.16)	Mellon	2136985
Total GBP	6/5/2003 10:29	\$0.00	6/2/2003	\$1.62980	\$0.00038	\$1.63018	234,678.36		
MCRF 09060002									
USD/EUR	05/08/03	\$34,802,083.56	06/05/03	\$1.14590	(\$0.00108)	\$1.14482	(30,399,611.78)	Mellon	2084638
USD/EUR	05/13/03	\$4,000,000.00	06/05/03	\$1.15370	(\$0.00086)	\$1.15284	(3,469,692.24)	Mellon	2093625
USD/EUR	05/19/03	(\$27,000,000.00)	06/05/03	\$1.16490	(\$0.00060)	\$1.16430	23,189,899.51	Mellon	2109600
USD/EUR	05/27/03	(\$5,000,000.00)	06/05/03	\$1.18720	(\$0.00030)	\$1.18690	4,212,654.82	Mellon	2128789
USD/EUR	06/05/03	(\$7,654,691.61)	06/05/03	\$1.18370	\$0.00000	\$1.18370	6,466,749.69	Mellon	
Total EUR	6/5/2003 10:29	(\$852,608.05)	6/5/2003	Amount to be Delivered on 6/5/3			0.00		
MCRF 09060002									
USD/CHF	05/08/03	\$48,915,393.42	06/12/03	1.31550	(0.001000)	1.31450	(64,299,284.65)	Mellon	2084633
USD/CHF	05/13/03	\$4,000,000.00	06/12/03	1.31360	(0.001030)	1.31257	(5,250,280.00)	Mellon	2093671
USD/CHF	05/19/03	(\$22,000,000.00)	06/12/03	1.29840	(0.000900)	1.29750	28,545,000.00	Mellon	2109628
USD/CHF	05/27/03	(\$3,000,000.00)	06/12/03	1.28320	(0.000280)	1.28292	3,848,760.00	Mellon	2128887
Total CHF		\$27,915,393.42	6/12/2003	1.31760	(0.000269)	1.30903			
MCRF 09060002									
USD/GBP	05/28/03	(\$14,000,000.00)	06/23/03	\$1.65307	(\$0.00217)	\$1.65090	8,480,222.91	Mellon	165,364
USD/GBP	06/02/03	\$10,000,000.00	06/23/03	\$1.62900	(\$0.00199)	\$1.62701	(6,146,243.72)	Mellon	(266,686)
USD/GBP	06/19/03	\$3,898,678.84	06/23/03	\$1.67040		\$1.67040	(2,333,979.19)	Mellon	
Total GBP Closed		(\$101,321.16)	6/23/2003	\$1.67040	(\$0.00192)	\$65,94476	(0.00)		(\$101,321)
MCRF 09060002									
USD/JPY	05/08/03	(\$21,643,468.56)	08/28/03	116.52000	(0.445000)	116.07500	2,512,265,613.10	Mellon	(381,895)
USD/JPY	05/27/03	(\$2,000,000.00)	08/28/03	116.92000	(0.380000)	116.54000	233,080,000.00	Mellon	(27,271)
Total JPY		(\$23,643,468.56)	8/28/2003	118.43500	(0.396924)	118.15916	2,745,345,613.10		(\$409,165.80)
MCRF 09060002									
USD/EUR	06/05/03	\$8,260,000.00	09/22/03	\$1.18370	(\$0.00370)	\$1.18000	(7,000,000.00)	Mellon	107,211
Total EUR		\$8,260,000.00	9/22/2003	\$1.16790	\$0.00001	\$1.16468	(7,000,000.00)		\$107,211.21
MCRF 09060002									
USD/CHF	06/10/03	\$30,000,000.00	08/25/03	\$1.31677	(\$0.00217)	\$1.31460	(39,438,000.00)	Mellon	24,943
Total CHF		\$30,000,000.00	8/25/2003	\$1.31760	\$0.00001	\$1.31569	(39,438,000.00)		\$24,943.16

6/19/2003